

**Finance And Economics: The dollar and the deficit; Economics focus**

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Abstract:

The dollar is not just a matter for America, because the dollar is not just America's currency. Over half of all dollar bills in circulation are held outside America's borders, and almost half of America's Treasury bonds are held as reserves by foreign central banks. The euro cannot yet rival this global reach. International financiers borrow and lend in dollars, and international traders use dollars, even if Americans are at neither end of the deal. No asset since gold has enjoyed such widespread acceptance as a medium of exchange and store of value. But America can play this role only if it is happy to allow foreigners to build up a huge mass of claims on its assets--and if foreigners are happy to go along. Some economists watch with consternation as the rest of the world's claims on America outstrip America's claims on the rest of the world. As they point out, even a dollar bill is an American liability, a promise of ultimate payment by the US Treasury.

Full Text:

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Why the dollar still rules the world--and why the world should be grateful

THE dollar is looking vulnerable. It is propped up not by the strength of America's exports, but by vast imports of capital. America, a country already rich in capital, has to borrow from abroad almost \$2 billion net every working day to cover a current-account deficit forecast to reach almost \$500 billion this year.

To most economists, this deficit represents an unsustainable drain on world savings. If the capital inflows were to dry up, some reckon that the dollar could lose a quarter of its value. Only Paul O'Neill, America's treasury secretary, appears unruffled. The current-account deficit, he declares, is a "meaningless concept", which he talks about only because others insist on doing so.

The dollar is not just a matter for America, because the dollar is not just America's currency. Over half of all dollar bills in circulation are held outside America's borders, and almost half of America's Treasury bonds are held as reserves by foreign central banks. The euro cannot yet rival this global reach. International financiers borrow and lend in dollars, and

international traders use dollars, even if Americans are at neither end of the deal. No asset since gold has enjoyed such widespread acceptance as a medium of exchange and store of value. In fact, some economists, such as Paul Davidson of the University of Tennessee and Ronald McKinnon of Stanford University, take the argument a step further (see references at end). They argue that the world is on a de facto dollar standard, akin to the 19th-century gold standard.

For roughly a century up to 1914, the world's main currencies were pegged to gold. You could buy an ounce for about four pounds or twenty dollars. The contemporary "dollar standard" is a looser affair. In principle, the world's currencies float in value against each other, but in reality few float freely. Countries fear losing competitiveness on world markets if their currency rises too much against the greenback; they fear inflation if it falls too far. As long as American prices remain stable, the dollar therefore provides an anchor for world currencies and prices, ensuring that they do not become completely unmoored.

In the days of the gold standard, the volume of money and credit in circulation was tied to the amount of gold in a country's vaults. Economies laboured under the "tyranny" of the gold regime, booming when gold was abundant, deflating when it was scarce. The dollar standard is a more liberal system. Central banks retain the right to expand the volume of domestic credit to keep pace with the growth of the home economy.

Eventually, however, growth in the world's economies translates into a growing demand for dollar assets. The more money central banks print, the more dollars they like to hold in reserve to underpin their currency. The more business is done across borders, the more dollars traders need to cover their transactions. If the greenback is the new gold, Alan Greenspan, the Federal Reserve chairman, is the world's alchemist, responsible for concocting enough liquidity to keep world trade bubbling along nicely.

But America can play this role only if it is happy to allow foreigners to build up a huge mass of claims on its assets--and if foreigners are happy to go along. Some economists watch with consternation as the rest of the world's claims on America outstrip America's claims on the rest of the world. As they point out, even a dollar bill is an American liability, a promise of ultimate payment by the US Treasury. Can America keep making these promises to foreigners, without eventually emptying them of value?

According to Mr Davidson, the world cannot risk America stopping. America's external deficit means an extra \$500 billion is going into circulation in the world economy each year. If America reined in its current account, international commerce would suffer a liquidity crunch, as it did periodically under the gold standard. Hence America's deficit is neither a "meaningless concept" nor a lamentable drain on world savings. It is an indispensable fount of liquidity for world trade.

Spigot by nature

But is the deficit sustainable? Many of America's creditors, Mr McKinnon argues, have a stake in preserving the dollar standard, whatever the euro's potential charms. In particular, a large share of America's more liquid assets are held by foreign central banks, particularly in

Asia, which dare not offload them for fear of undermining the competitiveness of their own currencies. "Willy nilly," Mr McKinnon says, "foreign governments cannot avoid being important creditors of the United States." China, for one, added \$60 billion to its reserves in the year to June by ploughing most of its trade surplus with America back into American assets.

This is not the first time America's external deficits have raised alarm. In 1966, as America's post-war trade surpluses began to dwindle, The Economist ran an article entitled "The dollar and world liquidity: a minority view." According to this view, the build-up of dollar claims by foreigners was not a "deficit" in need of "correction". Rather, the American capital market was acting like a global financial intermediary, providing essential liquidity to foreign governments and enterprises. In their own ways, Mr Davidson and Mr McKinnon echo this minority view today. A "correction" of America's current deficit, they say, would create more problems than it would solve. Whether the world's holders of dollars will always agree remains to be seen.

"Financial Markets, Money and the Real World" by Paul Davidson. Edward Elgar 2002.

"The International Dollar Standard and Sustainability of the U.S. Current Account Deficit" by Ronald McKinnon 2001. Available on

www.stanford.edu/~mckinnon/papers.htm

[Illustration]

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